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System is an administrative and investment retirement system created by State to provide retirement and other benefits to its member's employees. Pursuant to Statute, membership in System is limited to State municipalities and certain other public entities. System established Trust for the purpose of providing a method of pre-funding health care and welfare benefits for retirees, their spouse and dependents.

Contributions to Trust are used primarily to fund health insurance premiums and premium subsidies. Contributions may also be used to pre-fund disability, life, and long-term care benefits.

Trust is governed by System's board of trustees. The board consists of 15 trustees. All of the trustees are employees or officials of State municipalities. Ten of the trustees are elected officers of State municipalities and five are employees or appointed officers of State municipalities. The trustees are selected by the members of System.

Trust is administered by a program administrator. Initially, the program administrator will be Association, a nonprofit corporation organized under section 501(c)(4). Association's members are State municipalities. The program administrator accepts contributions from and disburses payment to Trust's participating employers. The payments distributed to the participating employer's are to be used in accordance with each participating employer's plan. Trust proposes to amend the Trust Agreement to clarify that the program administrator may be removed and replaced by a 2/3 vote of the trustees.

In order to become a participating employer in Trust, an entity's governing body must adopt a resolution electing to participate and enter into a participation agreement with Trust. Only a municipality or a public entity specified in Statute is permitted to become a participating employer in Trust. Further, Trust has amended the Trust Agreement to provide that in no case may an entity that is not a state, a political subdivision of a state or an entity the income of which is excluded from gross income under section 115 of the Code become a participating employer in Trust.

Trust's income is derived from employer contributions and investment income. Employees of the participating employers do not contribute funds to Trust or to their participating employer in connection with their post-employment health and welfare benefits premiums. The income of Trust is used solely to pay for retiree benefits and trust administration expenses. The sole purpose of Trust is to help its participating employers pay the cost of providing health and welfare benefits to retirees and other former employees and their spouses and dependents.

The Trust Agreement can be amended by the board of trustees. Trust has amended the Trust Agreement to provide that upon termination of Trust in no case will any remaining assets in Trust be distributed to an entity that is not a state, a political subdivision of a state or an entity the income of which is excluded from gross income under section 115 of the Code.

Trust represents that the following statement will appear in bold type at the top of the first page of the Trust and on the first page of every Participation Agreement:

“No guaranty that payments or reimbursements to employees, former employees or retirees will be tax-free. The Trust has obtained a ruling from the Internal Revenue Service concerning only the federal tax treatment of the Trust’s income. That ruling may not be cited or relied upon by the employer whatsoever as precedent concerning any matter relating to the employer’s health plan(s) (including post-retirement health plans). In particular, that ruling has no effect on whether contributions to the employer’s health plan(s) or payments from the employer’s health plans (including reimbursements of medical expenses) are excludable from the gross income of employees, former employees, former employees and retirees, under the Internal Revenue Code. The federal income tax consequences to employees, former employees and retirees depend on the terms and operations of the employer’s health plan(s).”

LAW AND ANALYSIS

Section 115

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under § 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utilities or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state’s participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct. In addition, pursuant to section 6012(a)(2) and the underlying regulations, the investment fund, being classified as a corporation that is subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers’ compensation, and employees’ health) is excludable from gross income under § 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Trust provides health benefits to retired employees of participating employers. All of Trust's participating employers are states, political subdivisions of states, or entities the income of which is excluded from gross income under section 115(1) of the Code. Providing health benefits to current and former employees of such government entities constitutes the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performs an essential governmental function within the meaning of § 115(1) of the Code.

The income of Trust accrues to its participating employers, all of which are states, political subdivisions of states or entities the income of which is excluded from gross income under section 115 of the Code. No private interests participate in or benefit from the operation of Trust. Any distribution of remaining funds in Trust to participating retirees upon the dissolution of Trust satisfies an obligation the participating employers have assumed with respect to providing health benefits to their employees. The benefit to the participating employees is incidental to the public benefit. See Rev. Rul. 90-74.

Based on the information and representations submitted by Trust we hold that the income of Trust is derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of § 115(1). Accordingly, Trust's income is excludable from gross income under § 115(1) of the Code.

Section 6012

Section 6012(a)(2) provides, in general, that every corporation subject to taxation under subtitle A shall make returns with respect to income taxes under subtitle A. In addition, section 1.6012-2(a)(1) of the regulations provides, in part, that every corporation, as defined in section 7701(a)(3), subject to taxation under subtitle A of the code shall make a return of income regardless of whether it has taxable income or regardless of the amount of its gross income.

Section 6012(a)(4) provides, in general, that every trust having for a taxable year any taxable income, or having gross income of \$600 or over, regardless of the amount of taxable income, shall make returns with respect to income taxes under subtitle a. Section 7701(a) and section 301.7701-4 of the regulations define trusts for purposes of section 6012.

Section 301.7701-1(b) of the Regulations provides that the the classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Code provides for special treatment of that organization.

Section 301.7701-4(a) provides that, in general, an arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. If an entity has both associate and a business purpose, it cannot be classified as a trust for federal income tax purposes.

Based solely on the facts submitted and the representations made, we hold that Trust is classified as a trust for federal income tax purposes under §301.7701-4(a). Accordingly, no annual income tax return must be filed by Trust pursuant to section 6012(a)(4) since any income realized by Trust is excluded from gross income under section 115(1).

No opinion is expressed concerning the federal tax consequences of the Trust under any other provision of the Code other than those cited above. In particular, no representation is made regarding the federal tax consequences of contributions to or payments from an employer's health plan(s), including (but not limited to) whether contributions to the plan(s) are excludable from the gross income of employees, former employees or retirees under section 106 and whether payments from the plan(s) (including reimbursements of medical expenses) are excludable from the gross income of employees, former employees or retirees under sections 104 or 105.

The participating employers are responsible for determining the tax status of all disbursements made to or on behalf of eligible recipients. The participating employers are also responsible for performing any tax reporting obligations resulting from any such disbursements.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that this ruling may not be used or cited as precedent.

Sincerely,

Sylvia F. Hunt
Assistant Chief, Exempt Organizations
Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)